Internal Revenue Service
memorandum
CC:TL-N-7651-91
RLHarrigal

date: JUN 27 1991

to: Regional Counsel, Manhattan CC:NA

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

ISSUE:

1) Whether premium shelfspace is an amortizable asset under I.R.C. § 167. 167.14-11

2) Whether the Service should amend its pleadings in the aforementioned dockets to argue as an alternative to the argument that premium shelfspace is not an amortizable asset, that certain costs incurred with respect to the acquired company's premium shelfspace should be capitalized under section 263 and, if so, what costs should be capitalized and over what useful life should these costs be amortized. 263.13-00

3) Certain employment contracts were acquired by [redacted] in the acquisition of [redacted]. The statutory notice stated that these contracts were not intangible assets subject to depreciation under section 167. While you brought this matter to our attention, you did not see any issue for us to address. 167.14-01

4) Whether the assembled workforce is an amortizable asset and whether costs associated with the assembled workforce should be capitalized. 167.14-19

CONCLUSION:

1) We believe that premium shelfspace is not an amortizable asset. Premium shelfspace represents the goodwill or going concern value of the acquired business and as such, is not amortizable. Additionally, we believe that the taxpayer may have overvalued the premium shelfspace. The appropriate method of valuation is the avoided or replacement cost since the taxpayer has no guarantee that its product will remain on the premium shelfspace.

2) We believe that the Service may amend its pleadings to raise capitalization as an alternative argument such that if the court finds that premium shelfspace is an amortizable, intangible

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asset, then certain costs associated with the taxpayer's premium shelfspace (which includes the premium shelfspace of the acquired company) should be capitalized. If a decision to amend the pleadings is made, we recommend that the costs which should be capitalized with respect to the acquired company's premium shelfspace, are the incremental costs used by the taxpayer in the valuation report to determine the incremental income stream due to premium shelfspace. Further, we recommend that the amended pleading, for purposes of the alternative argument, accept as the useful life for the capitalized costs (those related to the acquired premium shelfspace), the useful life that the court determines is proper for the acquired premium shelfspace. Finally, a section 481 adjustment may be required when the alternative argument is raised.[1]

3) We agree that under the facts presented, there does not appear to be an issue with respect to the employment contracts.

4) In our Tax Litigation Advice memorandum dated June 18, 1991, we addressed the issues of whether assembled workforce is an amortizable asset and whether costs associated with the assembled workforce should be capitalized.

FACTS:

During the period at issue, taxpayer acquired several companies including [redacted] and [redacted], and allocated a portion of the purchase price to several intangible assets including premium shelfspace, assembled workforce and employment contracts.

The taxpayer determined the amount to be allocated to the premium shelfspace by using the incremental net income stream--the difference between the net income stream for the premium shelfspace and the net income stream for normal shelfspace. In arriving at the premium shelfspace net income stream, the taxpayer deducted certain costs which included advertising, in-store promotions, coupons and retailer discounts.

The taxpayer acquired the employment contracts when it acquired [redacted] ("[redacted]"). [redacted] entered into employment contracts with [redacted] of its officers on [redacted]. Taxpayer claims that these contracts were necessary because of the officers in-depth knowledge of [redacted] and the relevant market. In [redacted], when the taxpayer acquired [redacted]. (by acquiring [redacted]

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[1] The section 481 comments provided in the Tax Litigation Advice memorandum dated June 18, 1991, apply equally to this issue. Those comments will not be repeated herein.

[redacted], which held all the stock of [redacted]) [redacted] years were left on the contracts.

The taxpayer, having allocated a portion of the purchase price to these intangibles, then claimed amortization deductions for the same.

The Service denied taxpayer's amortization deductions claiming that the amounts allocated to these intangible assets represent goodwill and going concern value for which amortization is not allowed. The Service claims that these assets do not have ascertainable fair market values or determinable useful lives. Additionally, the Service asserts that the amortization deductions taken by the taxpayer are unreasonable and do not clearly reflect income.

The Service is now considering an alternative argument with respect to the premium shelfspace (and the assembled workforce, as discussed in our June 18, 1991, memorandum), that if the premium shelfspace is held to be an intangible asset subject to amortization, certain costs related to that shelfspace should be capitalized.

<u>DISCUSSION</u>:

1) <u>Whether premium shelfspace is an amortizable asset under section 167</u>

The taxpayer is claiming that the value attached to the premium shelfspace, as compared to normal shelfspace, is an amortizable asset. The taxpayer values the premium shelfspace using the incremental income stream approach, that is, the difference between the net income stream of the premium shelfspace and the net income stream of the normal shelfspace.

Section 167(a) permits a depreciation deduction for the exhaustion of property used in a trade or business. Treas. Reg. § 1.167(a)-3 provides that an intangible asset may be amortized if the asset is of use in the business for only a limited period, the length of which can be estimated with reasonable accuracy. No depreciation deduction is allowable with respect to goodwill. Treas. Reg. § 1.167(a)-3. By implication, this provision extends to going concern value. <u>See</u> <u>United States v. Cornish</u>, 348 F.2d 175 (9th Cir. 1965) (going concern value is not amortizable as a matter of law).

"[T]he essence of goodwill is the expectancy of continued customer patronage, <u>for whatever reason</u>." <u>Boe v. Commissioner</u>, 307 F.2d 339, 343 (9th Cir. 1962) (emphasis added). Favorable location is one factor that contributes to the expectancy of continued customer patronage. <u>See</u>, <u>e.g.</u>, <u>Metropolitan Bank v. St. Louis Dispatch</u>, 149 U.S. 436, 446 (1893) (goodwill is the "'advantage or benefit ... in consequence of the general public patronage and encouragement which [the company] receives from constant or habitual customers, on account of its local position ...'"); Commissioner v. Seaboard Finance Co., 367 F.2d 646, 651 n.6 (9th Cir. 1966) (one of the usual goodwill characteristics is interest in the seller's locations). Competitive advantage in general also contributes to the expectancy of continued customer patronage. Wilmot Fleming Engineering Co. v. Commissioner, 65 T.C. 847 (1986).

In Winn Dixie Montgomery, the court held that an acquired business had substantial goodwill due to its unusually high earnings record and to the fact that it was the most successful retail food marketing operation in the vicinity. 444 F.2d at 681. The profitability of the seller's business was also cited as an element of goodwill in Computing & Software, Inc. v. Commissioner, 64 T.C. 223 (1975). See also Wilmot Fleming Engineering Co., 65 T.C. 847 (goodwill defined as "the expectancy of both continuing excess earning capacity and also of competitive advantage or continued patronage"). Goodwill exists in these instances because the revenues that produce high earnings are directly linked to customer patronage.[2]

Alternatively, favorable location represents the going concern value of an acquired company. Going concern value, as distinguished from goodwill, represents the ability of a business to continue to function and generate income without interruption due to the change in ownership. VGS Corp. v. Commissioner, 68 T.C. 563 (1977), acq., 1979-1 C.B. 1; Winn-Dixie Montgomery, Inc. v. United States, 444 F.2d 677 (5th Cir. 1971); Computing & Software, Inc. v. Commissioner, 64 T.C. 223 (1975), acq., 1976-2 C.B. 1. Going concern value can be found independent of goodwill. See VGS, 68 T.C. 563.

In Meredith Broadcasting Co. v. United States, 405 F.2d 1214 (Ct. Cl. 1969), the court found that the going concern value of an acquired radio station was nominal because the taxpayer was not satisfied with the calibre of the station's operating management and staff and did not believe that the station enjoyed any particular advantage due to community reputation. Conversely, when an acquired company has a competitive advantage in the business community, e.g., premium shelfspace, the

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[2] Note, however, that the level of profitability of a business is only one possible indication of goodwill. High earnings are not mandatory nor prima facie evidence of the existence of goodwill. Goodwill has been found in the absence of high earnings. See, e.g., Banc One Corp. v. Commissioner, 84 T.C. 476 (1985), aff'd without published opinion, 815 F.2d 75 (6th Cir. 1987).

purchaser has acquired going concern value which is not amortizable as a matter of law.

The value of premium shelfspace, like favorable location, emanates from goodwill since it derives its value from above normal customer patronage which is expected to continue. Alternatively, premium shelfspace provides the acquiring company with the ability to generate operating revenues without interruption. Thus, any advantage that premium shelfspace possesses is inextricably linked to either the goodwill or going concern value of an acquired business.

We also believe that the taxpayer's method of valuing the premium shelfspace may have resulted in overvaluation of the premium shelfspace. The value of the premium shelfspace should be no greater than the initial costs to obtain that shelfspace. The taxpayer has no guarantee that its product will remain on the premium shelfspace. Any future income stream is related to continuing costs incurred by the taxpayer. Accordingly, the avoided or replacement cost is a more appropriate measure of the value.[3]

2) <u>If premium shelfspace is an amortizable asset, whether certain costs associated with such shelfspace should be capitalized and, if so, which costs and over which useful life</u>

The valuation report indicates that the costs incurred for the premium shelfspace include advertising, in-store promotions, coupons and retailer discounts. Presumably, the taxpayer has expensed these items to the extent it has incurred them for acquired premium shelfspace.

Under section 162, all ordinary and necessary business costs are currently deductible. Section 263(a), which overrides section 162, provides that no deduction shall be allowed for any amount paid for permanent improvements or betterment made to increase the value of any property, or for any amounts expended in restoring property or in making good the exhaustion thereof

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[3] We would also like to note a potential issue with respect to the useful life of the premium shelfspace. The valuation report indicates that the useful life of the shelfspace rests on product lifecycle. Valuation Report at 75. To the extent that the product occupying the premium shelfspace has expired its life cycle, current expenses will not retain the premium shelfspace for that product. This result, however, is a function of the product's life, not the useful life of the shelfspace. It may be that the company holding premium shelfspace can with relative ease replace one product on the premium shelfspace with another product with comparable sales, making the useful life of the premium shelfspace indeterminable.

for which an allowance is or has been made. See Commissioner v. Idaho Power Co., 418 U.S. 1 (1974). All costs incurred to create an asset separate and distinct from goodwill must be capitalized to the asset so created. Commissioner v. Lincoln Savings & Loan, 403 U.S. 345 (1971).

In Briarcliff Candy Corp. v. Commissioner, T.C. Memo. 1972-43, rev'd, 475 F.2d 775 (2d Cir. 1973), the taxpayer sought section 162 deductions for expenses which included the placement of advertising in drugstore trade journals, and the preparation of advertising circulars mailed to drugstores nationwide. The purpose of this advertising campaign was to convince the proprietors of drugstores to establish departments within their stores for the distribution of taxpayer's candies on a retail basis.

The taxpayer asserted that the amounts expended were ordinary and necessary business expenses, fully deductible in the year incurred. The Service argued that the expenditures constituted a capital investment and therefore should have been capitalized under section 263. The Tax Court held that the expenses were not deductible under section 162. The court noted that expenditures such as advertising may be deemed capital expenditures when "made for the cultivation or development of business, the benefits of which will be realized in future years."

The Tax Court's opinion in Briarcliff was reversed on appeal because the court did not find a separate and distinct asset. In reversing, the appellate court stated that "in the absence of the acquisition of a capital asset,... expenses for advertising and promotion should be deductible under section 162." 475 F.2d at 784. See also Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220 (1985) ("if advertising serves the predominate purpose of contributing to the acquisition of a capital asset, tangible or intangible, ... the cost of such advertising is not deductible for the taxable year"); Alabama Coca-Cola Bottling Co. v. Commissioner, T.C. Memo. 1969-123 (advertising expenses creating five year benefit should be capitalized); Sara Lee Corporation, GCM 39,483, I-135-85 (Mar. 5, 1986) ("... nonrecurring promotional or advertising expenses resulting in benefits to the taxpayer extending beyond the year the expenses are incurred are properly regarded as a capital investment."); Central National Bank of Cleveland, GCM 35,116, I-4895 (Nov. 14, 1972) (finding advertising expenses should be capitalized).

There is some language in the GCMs and some cases cited therein which suggests that the determination of whether an expense should be capitalized or deducted depends, at least in part, on whether the expense is a recurring expense. We do not believe that this language prevents capitalization under the alternative argument even if the costs to be capitalized are recurring in nature.

First, our initial position that premium shelfspace is not amortizable is consistent with the notion that these expenses should be deducted. The alternative argument set forth herein requires that the court first find that premium shelfspace is an amortizable asset. Once found, the court would be implying that the costs (recurring though they may be) that created (obtained), enhanced the value of, or extended the useful life of the asset are to be capitalized. Idaho Power Co., 418 U.S. 1.

Second, to the extent that the authorities have used the fact that costs are recurring as indicating that the costs are maintenance costs (and are thereby deductible), the recurring costs for premium shelfspace continue the life of the shelfspace and, as such, are more than maintenance expenditures. If the taxpayer does not continue to pay these costs for the premium shelfspace, the taxpayer indicates that it will no longer be provided with premium shelfspace. Valuation Report at 38.

Thus, if a court finds that premium shelfspace is an amortizable, intangible asset, the Service may argue that the costs incurred to create, enhance the value or restore or "make good" the exhaustion of the premium shelfspace should fall within section 263 and not section 162.

As with the capitalization argument for the assembled workforce (addressed in our June 18, 1991, memorandum), the alternative argument applies, theoretically, to all relevant expense deductions taken by the taxpayer (and any members of a consolidated group of which the acquiring company is a member), before or after the acquisition (to the extent such entity had premium shelfspace). But, we recognize that the decision of whether to extend the alternative argument in this manner is a strategic decision, best left for the field to decide. We note though that the method we recommend for deciding which costs to capitalize (see below) may not apply to shelfspace other than the acquired premium shelfspace, thereby making it difficult to arrive at a disallowance for the related entities.

If you decide to raise the alternative argument, we believe that the taxpayer has provided us with the costs to be capitalized for the acquired premium shelfspace. By providing the incremental net income stream, the taxpayer has already notified us of what costs are necessary for the increased revenue (i.e, the value) from the premium shelfspace. We recommend disallowing the section 162 expenses to the extent of the costs provided. For example, it appears from the valuation report that in the year of acquisition, the taxpayer anticipated that the cost of the premium shelfspace would be $[redacted] (for the [redacted]), $[redacted] (for the [redacted]),

$[redacted] (for the [redacted]) and $[redacted] (for the [redacted]); totalling $[redacted] of disallowed section 162 expenses.[4]

We do not know the extent to which the costs incurred for the premium shelfspace amortized by the taxpayer reflect the costs that the taxpayer and other companies, i.e., related entities, incur for other premium shelfspace. Even if the costs incurred by one company for a unit of premium shelfspace is indicative of costs another company must incur for premium shelfspace, the related entities may have more or less premium shelfspace. Given this uncertainty, we are hesitant to recommend using the cost numbers provided in the valuation report for the related entities or for any other premium shelfspace held by the taxpayer. Further, since the taxpayer used the income stream approach to value the premium shelfspace instead of an avoided cost approach, it may be more difficult to do initial discovery for premium shelfspace than it would be for the assembled workforce.[5]

With regard to the useful life to assert for the capitalized costs, we recommend for the reasons set forth in our June 18, 1991, Tax Litigation Advice memorandum, that the Service accept, for purposes of costs related to the acquired premium shelfspace, the useful life that the court determines is proper (i.e., we recommend inserting in the amended pleading that the useful life of the costs which go to enhance the value of or to restore such shelfspace is the life alleged by the taxpayer or the useful life as determined by the court). If, however, you decide to raise the alternative argument with respect to other premium shelfspace of other companies within a consolidated group (e.g., the workforce of a brother company) or other premium shelfspace of the acquiring company, we recommend remaining silent as to the useful life in the amended pleadings, leaving the taxpayer to prove its entitlement to amortization of any such shelfspace.

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[4] You sent us a copy of the Notice of Proposed Adjustment, form 886-A, Explanation of Items pertaining to the "Deal" expenses which appears to set forth the amount of expenses for "deals." It is not clear whether these expenses are the same as the premium shelfspace expenses. If these numbers are the actual premium shelfspace expenses, they would, of course, be better to use than the anticipated costs reflected in the incremental cash flow analysis in the valuation report.

[5] This later problem may be overcome if we allege that the premium shelfspace should be valued using the avoided or replacement cost approach.

Additionally, if the Service raises the alternative argument a section 481 adjustment may be necessary. Please consult the June 18 Tax Litigation Advice memorandum on this issue.

3) Employment Contracts

According to the taxpayer's petition, on [redacted], taxpayer acquired [redacted] which held all the stock of [redacted]. [redacted] had employment contracts with three of its officers. These employment contracts were entered into on [redacted]. At the time of the acquisition, there were approximately [redacted] years left on the contracts. The taxpayer claims that these contracts were necessary because of the officers' in-depth knowledge of [redacted] and the relevant market.

The agent disallowed amortization of these contracts, stating that they were not assets within the meaning of section 167(a) since they were inseparable from the goodwill and going concern value of the acquired business. Additionally, the agent stated that the value and useful life of the contracts has not been established and finally, that the method of amortization is unreasonable and does not clearly reflect income.

In Barnes Group, Inc. v. United States, 872 F.2d 528 (2d Cir. 1989), the court held that the applicable test for determining if employment contracts are an asset of the acquired business is whether: 1) the employment contract was entered into prior to the sale of the acquired company; 2) the employment contract was not conditioned upon the sale of the acquired company and if the above two conditions are met; 3) the acquired company had a substantial business purpose independent of the proposed sale for entering into the employment contract.

Under the facts presented by the taxpayer, the contract was entered into approximately eight months before the acquisition. There is nothing to indicate that the contract was conditioned upon the sale of the contract. Indeed, the contract apparently was in force from the time it was entered into. Further, the taxpayer has suggested a valid business reason for entering into the contracts.

We understand that you did not see any issue in the employment contracts that we needed to address. Based on the facts before us, we agree. If further development of facts indicates that further analysis is necessary, we will be happy to provide the same at that time.

4) Amortization of the assembled workforce and, alternatively, capitalization of costs associated with the assembled workforce

These issues were addressed in our June 18, Tax Litigation Advice memorandum.

Please call Rebecca L. Harrigal at FTS 566-4189 for assistance as you proceed with determining exactly which costs should be the subject of your amended pleading and for determining the amount of the section 481 adjustment and for any assistance you require in drafting such pleading.

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